REPORT TO THE SENATE COMMITTEE ON LABOR AND PUBLIC WELFARE

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

The Investment Decisionmaking Process In Two New Jersey Public Employee Retirement Plans

This report is the first in a series of seven projected studies requested by the committee.

It contains case studies on the Public Employees' Retirement System of New Jersey and the Board of Education Employees' Pension Fund of Essex County, New Jersey, giving details of the structure and operations of the plans.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the Chairman and
Ranking Minority Member
Committee on Labor and
Public Welfare
United States Senate

In response to your June 14, 1975, letter, we are making a series of case studies of fiduciary standards and conduct of public employee pension plans maintained by State and local governments in New Jersey, New York, Tennessee, Colorado, Georgia, Virginia, and Michigan.

In New Jersey, we studied the Public Employees' Retirement System of New Jersey and the Board of Education Employees' Pension Fund of Essex County. Case studies of these plans are included as appendixes I and II; case studies of the public employee pension plans of the other six States will be provided later.

Based on discussions with your office, we developed a framework for the case studies to provide the information needed to help the Committee fulfill its statutory obligation to study governmental retirement plans. The Employee Retirement Income Security Act of 1974 directed the Committee to undertake such studies and provided that the results should be reported to the Senate not later than December 31, 1976. Because of time limitations, it was agreed that we would obtain information on the investment decisionmaking process from summary data and interviews with cognizant officials. We did not verify the information obtained, and we are not commenting on the adequacy of procedures and practices followed by the plans.

The Public Employees' Retirement System of New Jersey has the largest membership of the six pension plans for which investments are administered by the State. This plan covers 171,518 active members and 21,632 pensioners; the other plans cover 137,216 active members and 30,062 pensioners. As of June 30, 1975, this plan had $1.1 billion in investments compared to $2.5 billion for the other five plans.

This plan is the result of a 1954 State law which established a comprehensive and more uniform pension structure within New Jersey. The plan's operation is separated into two functions: (1) administration of the plan and (2) investment of plan assets.

A board of trustees is responsible for general administration, including adopting rules and regulations covering payment of benefits and collection of funds. Actual administration of the plan is carried out by the Division of Pensions. All investment functions--purchase, sale, or exchange of securities--are the responsibility of the Division of Investment. Investment procedures and policies to be followed by the Division of Investment are formulated by a State Investment Council. Organizationally, the council is located within the division; however, the council independently reports annually to the Governor, the legislature, and the State treasurer. Both divisions are part of the Department of the Treasury.

The Board of Education Employees' Pension Fund of Essex County is 1 of 38 identified contributory plans serving public employees in New Jersey. As of December 31, 1975, it had 5,532 active and 518 retired members and assets totaling $36 million.

This plan was established in accordance with the statutes of New Jersey and covers the noninstructional employees of 21 Essex County school districts. A board of trustees, independent of the district boards of education, is responsible for plan operations. An executive secretary administers the plan and a local bank manages its investments.

The investment decisionmaking processes are discussed in detail in the case studies. As directed by your office, this report has been finalized without waiting for formal written comments from plan officials. However, we discussed the case studies with plan officials, who agreed with the facts presented. Where appropriate, their comments were included in the case studies. We have requested formal written comments, which we will send to you when we receive them.

Elmer B. Staats

Comptroller General
of the United States

APPENDIX I

CASE STUDY

ON

THE PUBLIC EMPLOYEES'

RETIREMENT SYSTEM

OF

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CHAPTER 1

BACKGROUND

The Public Employees' Retirement System of New Jersey (hereafter referred to as the Plan) was established on January 2, 1955, under Chapter 84, Public Laws of 1954 of the State of New Jersey. This act repealed the provisions of the State Employees' Retirement System established in 1921 and transferred responsibility for benefits in effect to the Plan. As of June 30, 1975, the Plan had 171,518 active members and assets totaling over $1.1 billion. The Plan had the largest active membership of all plans administered by the State and was only exceeded in assets by the Teachers' Pension and Annuity Fund. During June 1975, the Plan paid about $4.7 million to its 21,682 retirees and beneficiaries.

In addition to the Plan and the Teachers' Pension and Annuity Fund, other pension plans managed at the State level included the (1) Consolidated Police and Firemen's Pension Fund, (2) Judicial Retirement System, (3) Police and Firemen's Retirement System, and (4) State Police Retirement System. Administrative and investment activities of pension plans are handled by two divisions under the State's Department of the Treasury. The Division of Pensions administers the pension plans, and the Division of Investment invests pension plans' funds.

MEMBERSHIP REQUIREMENTS

Membership in the Plan is normally required for all public employees who are not required to become members of any other contributory retirement program. Membership is made up of:

--State employees, including persons who are on county or municipal payrolls but whose positions have been legally defined as those of State employees (such as employees of the courts).

--Employees who have been permitted to enroll in the Plan as a result of a referendum or resolution in the county, municipality, or public agency where this is appropriate.

--All employees holding positions covered by the retirement system who were hired after July 1, 1966.

In 1953, the predecessor plan adopted two classes of membership--Class A, which applies to some members enrolled before 1953, and Class B, which offers one-sixth greater benefits and applies automatically to all members enrolled since 1953. Members enrolled before 1953 were permitted to make additional contributions and become Class B members. Virtually all members are in Class B. The Plan, established in January 1955, continued the two classes of membership.

Individuals not eligible for membership include (1) temporary or seasonal employees, (2) employees earning less than $500 annually, (3) employees who are members of another contributory retirement system, or (4) employees who are otherwise eligible but are retired members of another public retirement system in New Jersey or any other State.

FUNDING

Funds needed to finance the Plan come from contributions by both the employee and employers (that is, State, county, and municipal governments and their instrumentalities) and from earnings on investments. Members contribute a percentage of their salary based on their sex and age at enrollment. For example, a male enrolling at age 18 contributes 4.81 percent of his salary, whereas a male enrolling at age 59 contributes 8.45 percent. Females of the same ages at enrollment contribute 5.23 percent and 9.51 percent, respectively.

The State and local employers' contributions to the retirement system are based on an annual valuation by an actuary. Their contributions are determined as the percentage of future compensation of members which will support the pension and death benefits payable by the Plan and which are not met by anticipated future employee contributions, investment income, and the funds on hand available for such benefits. In fiscal year 1975, overall employers' contributions amounted to 6.94 percent of employees' gross wages.

BENEFITS

The Plan provides its members or beneficiaries with a guaranteed retirement income for life and financial protection in the event of disability or death.

Normal retirement benefits

The normal retirement benefits are available to members at age 60 with no minimum years of service required. A member with 25 years or more of service can retire with full benefits between ages 55 and 60. The benefits are reduced by 0.25 percent for each month under age 55. Members must retire at age 70 unless employers request an extension.

Regular retirement benefits are determined based on a percentage equal to one-sixtieth (Class B) or one-seventieth (Class A) for each year of credited service multiplied by the retiree's 3-year final average salary (that is, the average salary for the last 3 years or the highest 3 fiscal years of membership service, whichever is higher). For example, assuming a 3-year final average salary of $8,005, a Class B member with 30 years of service would receive yearly benefits of $4,002.50 (1/60 x $8,005 x 30).

Disability retirement benefits

A member qualifying for ordinary disability retirement is entitled to an allowance equal to 1.5 percent of his 3-year final average salary for each year of credited service. The allowance cannot be less than 40 percent of the final average salary or more than 90 percent of the regular service retirement allowance which the member would have received had he remained in service until reaching age 60.

A member qualifies for accidental disability retirement regardless of age if he becomes totally and permanently incapacitated before age 65 as a direct result of an accident on the job. A qualifying member receives an allowance equal to two-thirds of the salary he was receiving on the date of the accident.

Cost-of-living annuity increases

Legislation amended in 1971 provides that pensioners of the Plan and all other State-administered retirement plans will be paid a pension adjustment calculated at one-half of the change in the Consumer Price Index since their retirement. This adjustment is paid only after the pensioners have been retired for at least 3 full calendar years. Pension increases are not charged against the assets of the Plan or the basic retirement plans; pension increase funds are provided by separate State and local employer annual appropriations.

Other benefits

Another benefit provided to Plan members is group life insurance. Members are insured at 1-1/2 times their annual salary. Additional coverage at 1-1/2 times their salary is available on a contributory basis. Also, Plan members with at least 3 years of service may borrow from the Plan an amount equal to 50 percent of their accumulated contributions at 4-percent interest.

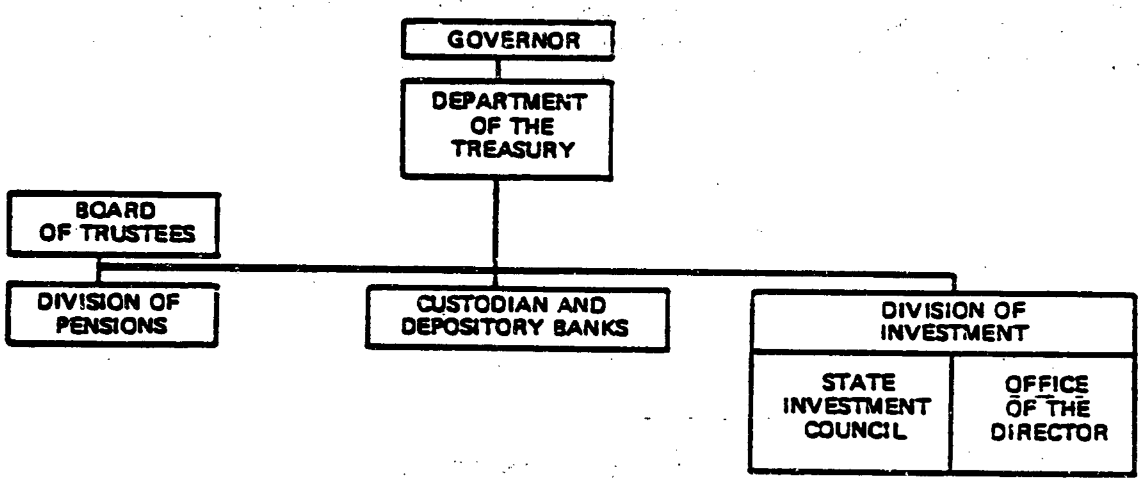
CHAPTER 2

FRAMEWORK FOR MANAGING INVESTMENTS

Under enabling legislation, the general administration responsibility for Plan operations is vested in a board of trustees. State legislation enacted in 1955 assigned administrative functions of all State pension plans to the Division of Pensions under the State's Department of the Treasury. In addition, all board duties dealing with the investment of Plan funds were transferred to the Division of Investment, also under the Department of the Treasury. Within the Division of Investment, a State Investment Council was created with authority to establish and formulate investing policies to be followed by the Division of Investment. The State treasurer selects custodian and depository banks for Plan assets.

ORGANIZATIONAL STRUCTURE

The following structure was established to administer and manage the Plan.



Board of trustees

The board is required by statute to have the following nine members:

--Two trustees appointed by the Governor, serving at the Governor's pleasure. They must be private citizens of the State but cannot be State officials or active or retired members of the Plan. Appointees have usually been businessmen and have come from throughout the State.

--The State treasurer or the deputy treasurer if designated by the treasurer.

--Three State employees who are members of the Plan are elected for 3 years by fellow State employees.

--Two municipal employees who are members of the Plan are elected for 3 years by fellow municipal employees.

--One county employee who is a member of the Plan is elected for 3 years by fellow county employees.

Each member is required to take an oath of office that he will diligently and honestly administer the board's affairs and will not knowingly violate or willfully permit the violation of laws applicable to the Plan. There are no legal restrictions regarding political party affiliations. Board members serve without pay but are reimbursed for any necessary expenditures.

All responsibilities relating to the investment of Plan funds were transferred by legislation from the board to the director of the Division of Investment. The investment decisionmaking process is described beginning on page 12.

The board is responsible for the proper operation of the Plan. Because legislation cannot cover all the complications arising in the administration of a retirement program, the board is responsible for developing implementing policies. The board:

--Adopts rules and regulations covering payments of benefits and collection of funds as required by law.

--Establishes rules and regulations designed to prevent injustices and inequities which might arise in the operation of the Plan.

--Grants hearings to members who disagree with their decisions.

--Prepares annual reports of the assets and liabilities and the income and disbursements and a statistical summary of the Plan's membership.

Division of Pensions

In July 1955, the Division of Pensions was created by New Jersey law to administer the functions of all State pension plans subject to the rules, regulations, and decisions of the respective boards of trustees, legislation, court decisions, and opinions of the State attorney general.

The division succeeded the Bureau of Public Employees' Pensions, created in June 1952 to centrally administer State retirement systems. Before then, each retirement plan was independently administered.

The Division of Pensions, which consists of about 270 employees, is responsible for the administrative operations of all State pension funds. Division personnel also administer other programs, such as the State Agency for Social Security and State Health Benefits program. The division's operations are established along functional lines so that administrative bureaus and sections provide for the payments of benefits and the collection of moneys under these various programs uniformly and systematically.

State legislation required the director to be qualified by training and experience to direct the division. The director is appointed by the Governor. Other division employees are selected and hired under the State's civil service system. There are no restrictions regarding political party affiliations.

Division of Investment

This division was created in July 1950 by New Jersey legislation to centralize all functions dealing with the purchase, sale, or exchange of securities under experienced and professional management. The division is the State's in-house investment manager.

State Investment Council

New Jersey statutes established a State Investment Council within the Division of Investment. The council's role is to formulate investment procedures and policies to be followed by the division. The council is authorized to inspect and audit the funds managed by the division. It reports annually on its work and the division's work to the Governor, the legislature, and the State treasurer.

The council consists of 10 members who serve without compensation. The Governor appoints five members for staggered 5-year terms. At least three of the five should be qualified by training and experience in investment and finance. The boards of trustees of five pension plans, including the Plan, each designate a member to serve a 1-year term on the council. Legislation provides that no council members should hold any office, position, or employment in any political party or benefit directly or indirectly from any transaction made by the Division of Investment.

Office of the Director

The Division of Investment employs 42 people, including a staff of 13 who make the investment decisions. The division manages investments of $4.4 billion for 50 State funds, including the Plan and five other pension plans. In addition, as a service, the division handles investments for 43 funds of State agencies, such as the Economic Development Fund, Housing Finance Agency, and Mortgage Finance Agency, with investments totaling about $400 million.

The director is appointed by the State treasurer from a list of candidates submitted by the State Investment Council. The director can be removed by the treasurer for cause or upon vote of 7 of the 10 council members. The deputy director is appointed by the treasurer, subject to approval by the council. All other staff members, such as traders, portfolio managers, and investment analysts, are selected and hired under the State civil service system.

MAKING AND IMPLEMENTING INVESTMENT POLICY

Investment policies

New Jersey legislation provides the Division of Investment with the functions, powers, and duties relating to the investment of pension plan funds as guided by law and the council's regulations. Funds collected by the Division of Pensions are made available to the Division of Investment for investment under the authority of the board as trustee for the Plan. The Assistant Director, Division of Pensions, advised us that under New Jersey laws, the Governor and the State legislature have no control over Plan funds.

The first set of guidelines followed by the Division of Investment is the laws governing investments. Before 1950, investments were limited to U.S. Government and municipal obligations; 1950 legislation offered opportunities to purchase obligations which were legal investments for savings banks within the State. Later amendments to the 1950 legislation increased the scope of potential investment opportunities to allow a more diversified portfolio. Under current legislation, the division may

--establish, maintain, and operate one or more common trust funds which may be combined for the purpose of investment and

--invest funds in securities in which a fiduciary of a trust estate in the State may legally invest.

All changes in law since 1950 have added to the division's responsibility. The laws serve as the criteria for the council to use in establishing investment guidelines. The council's guidelines restrict the investments to those that possess such qualifying characteristics as minimum interest coverage on bonds, years of dividends on stocks, or listing on a national stock exchange. The guidelines also restrict the amount of investment, such as by limiting the total amount of common stock that can be purchased or the percentage of funds that can be invested in any stock or in securities of any company.

The council also establishes policy and procedures at its monthly meetings. Division officials indicated that investment policy is directed toward preserving the capital and maintaining adequate liquidity of assets while optimizing the rate of return. They added that no specific rate-of-return objectives were established because the State legislature and the council wanted to avoid unduly limiting investment opportunities.

The following guidelines have been established to govern pension fund investments.

Bonds

Permissible bond investments include (1) corporate obligations that are legal investments for savings banks or life insurance companies, (2) U.S. Treasury and Government agency obligations, (3) senior debt securities of finance companies, (4) bank debentures, (5) Canadian corporate and government obligations, (6) New Jersey State and municipal general obligations, and (7) public authority revenue obligations.

Not more than 10 percent of the Plan's assets can be invested in Canadian obligations nor can more than 2 percent be invested in obligations of any one Canadian issuer. A number of restrictions have also been placed on bond investments within the United States. For example, the division may invest in any corporate obligations that are legal investments for savings banks in the State, provided that the total amount of debt issues of any one corporation purchased or acquired shall not exceed 10 percent of the outstanding debt of the company, and not more than the greater of $10 million, or 10 percent of any one issue.

Mortgages

Permissible mortgage investments include military family housing, Federal Housing Administration-insured mortgages, and Veterans Administration-guaranteed mortgages. The restrictions differ for the various types of mortgages. The division may invest in military family housing mortgages provided that not more than 15 percent of the assets of any pension fund is invested. The division may also invest in any Federal Housing Administration-insured mortgage not less than $1 million or more than $8 million. The book value of all mortgages held by the Plan shall not exceed 20 percent of the assets of the pension fund.

Stock

Permissible stock investments for pension funds consist of common and preferred stocks and issues convertible into common stock. Restrictions on stock investments include:

--The book value of the total investment in common and preferred stock for any one plan's fund shall not exceed 25 percent of the book value of such plan's fund.

--Not more than 2 percent of the book value of any plan's fund shall be invested in the common and preferred stock of any corporation.

--The total amount of stock purchased or acquired from any corporation shall not exceed 5 percent of the common stock or any other class of stock that entitles the holder thereof to vote at all elections of directors of such corporation.

Short-term investments

Short-term investments include commercial paper, such as secured or unsecured promissory notes, and certificates of deposit. Commercial paper may be purchased for any pension fund providing that maturity does not exceed 180 days. Certificates of deposit of commercial banks may be purchased provided that the total amount of the certificates in any bank does not exceed 25 percent of a bank's net worth.

The amount of the Plan's assets that can be invested in short-term securities is not limited. However, the Plan's practice has been to invest assets in long-term securities as rapidly as possible. During the last 5 years, the Plan's investments in short-term securities have averaged about 3 percent.

Common funds

Within the Division of Investment, the following three common pension funds have been created for combining investments:

--Fund A is an equity fund participated in by five of the pension plans. Moneys are allocated to the common fund monthly to purchase stocks in that particular month. The amount may be increased or decreased depending on the level and expected trend of the market.

--Fund B is used to invest in fixed income and debt securities (bonds) that are legal investments for savings banks or life insurance companies organized under the laws of the State.

--Fund C was established to consolidate purchases of short-term fixed income securities to provide liquidity for the pension funds and to try to increase the rate of return by taking advantage of daily fluctuations in the money markets.

Real estate investments

Subject to the approval and acceptance of the board, the Division of Investment is authorized to (1) invest in real property in New Jersey on behalf of the Plan, (2) erect buildings, structures, and make improvements, and (3) rent, lease, or sell such realty, after initial rental to the State. Such investments must be solely for rent or lease to the State and must not exceed 5 percent of the book value of Plan investment holdings. Present Plan holdings consist of New Jersey Department of Health and Agriculture buildings.

Implementing investment policy

The council, at its regular meetings, makes policy decisions regarding the amounts and types of investments that are appropriate for each fund managed by the Division of Investment. Based on these decisions, the division develops an overall annual strategy for investment. The strategy is translated into specific investment guidelines by the director and his staff at monthly and weekly meetings. (Daily strategy meetings are also held if market conditions warrant.) In setting these guidelines, the director refers to computer-prepared reports, which show the current status of each fund compared to the investment policy limits and the cash flow available for investment over the next week, month, and 3 months. The staff's daily decisions are based on guidelines established at these meetings. The division's goal is to increase its equity holdings to 20 percent without sacrificing income while maintaining the safety of principal.

Experience of investment decisionmaking staff

The division has 13 professional staff members managing day-to-day investment activities. Some were hired from professional firms; others gained their expertise through extensive experience with the division. Qualifications and work experience of key positions are summarized below.

1. Director--The incumbent, who has held this position for the past 11 years, came to the division with broad investment and administrative background. He served as vice president and treasurer of Ethicon Corporation, a subsidiary of Johnson and Johnson Corporation, and was a partner in Hewitt and Stoddard, a registered investment advisory firm in New York City.

2. Deputy director--The incumbent has been with the division for 1 year. Before his appointment, he was vice president of Morgan Stanley and Company, an investment firm.

3. Investment officer--The investment officer, the chief of the Portfolio and Trading Section, is responsible for developing and implementing portfolio strategy and supervising the investment decisions recommended by portfolio managers. The position requires 10 years of professional ex-experience with an investing entity (for example, a bank or insurance company) with primary accountability and authority for managing at least $300 million. The incumbent has been with the division for 22 years.

4. Research officer--The research officer, the chief of the Research Section, is responsible for developing and implementing the investment research policies and guidelines required for managing the investment of funds totaling billions of dollars. The position requires 10 years of professional experience with a public or private entity engaged solely in institutional investment research, including at least 4 years as manager of an entire investment research department. The incumbent came to the division 2 years ago from Waltston and Company, where he was senior vice president and director of institutional research.

5. Supervising securities market trader--The incumbent, the manager for bond and stock trading, is responsible for directing trading strategy and supervising market decisions for the Trading Section. The position requires 5 years of professional experience as a stock or bond trader with an investing entity. The incumbent must have also had accountability and authority to negotiate terms and execute purchases, sales, and exchanges of securities of at least $100 million. The incumbent, who previously was with the Chase Manhattan Bank, has been with the division for 10 years.

6. Portfolio manager--Individuals in this position are responsible for analyzing and managing portfolios consistent with the goals of the division. The position requires 3 years of professional experience with an investing entity having accountability and authority for management of at least $50 million. The division employs two common stock portfolio managers, both of whom have been with the division for over 6 years.

7. Principal investment analyst--The incumbent has been with the division for 6 years. He is responsible for monitoring the fundamental operations of companies and preparing

analyses of stocks, bonds, and other securities. He prepares fund analyses and monitors the legality of investments. The position requires 5 years of professional experience with a private or public entity engaged solely in institutional investment research.

The turnover of personnel is a constant concern of the division director. During the past few years, 6 of 13 staff members left the division. Most were young persons, who after acquiring expertise, were offered greater financial opportunities by other financial organizations.

Selection of brokers

Division officials said all investment transactions are made competitively. To maintain conditions of competition among investment firms, the Division of Investment dealt with 229 brokers during fiscal year 1975. This includes firms which act as principals or agents in issuing commercial and financial paper, banks whose certificates of deposit are obtained competitively, investment firms which serve as agents of unregistered securities, and suppliers of Federal Housing Administration-insured mortgages.

The division recognizes the investment banking and brokerage community as a valuable resource for research, evaluation, and statistical services. These services can be purchased with cash or obtained by "soft dollar" commissions--the receipt of research from broker-dealers in exchange for commission business. The division currently pays "soft dollars" to obtain such services.

The division has developed an evaluation system to identify firms providing the most useful services. Division staff rate each firm by categories, such as its ability to perform and the quality and usefulness of its services. Based on the ratings, the division divides the firms into five groups. The ratings are reevaluated semiannually. Common stock commissions and a portion of purchases of new issues of bonds are allocated to firms qualifying through this evaluation. Firms with higher ratings receive greater allocations of these commissions. During fiscal year 1976, about 30 percent of total commissions were paid to firms with offices in New Jersey.

The division paid about $925,000 in commissions for stock transactions during fiscal year 1975. Information on total commission fees for purchase of new issues of bonds was not available because fees are included in the purchase and sale price and are not identified as a separate cost. Division officials, however, estimate that commissions for all bond transactions in fiscal year 1975 totaled about $1 million.

MANAGEMENT AND CONTROL OF PENSION PLAN ASSETS

The Division of Pensions manages two cash accounts. The management of the accounts and the relationship between this division and the Division of Investment with respect to investing excess cash are discussed on page 25. The techniques used to insure that cash is being invested to increase interest return and to insure security of investment are outlined below.

Money management techniques

To increase interest return, the Division of Pensions notifies the Division of Investment of excess cash available for investing daily. This daily notification practice is so refined that cash available for investment includes cash that has been excess for only a short time--as little as 2 days. In such instances, the Division of Investment immediately invests in short-term securities, such as commercial paper, which will mature on the date cash is needed. Thus, interest income is derived from funds which are not immediately needed to pay benefits but which are not available for long-term investments.

Other techniques involve using the three common trust funds (see p. 15) for investing moneys of the Plan as well as other pension plans. Losses are distributed on the basis of units of ownership. The risk is therefore not limited to any one pension plan.

Monitoring investment performance

The council reviews the investment performance of the Division of Investment by using an independent fund evaluation service. Reports issued by this service provide an overview of fund performance and are designed to permit timely consideration of investment performance over certain short- and intermediate-term periods in relation to policies, goals, and objectives. The council indicated that the division's investment results were comparable to results achieved by other investment managers.

The council also commissioned the services of an outside financial consultant to study the status of the Division of Investment's responsibilities and activities as of the end of fiscal year 1972. The consultant's May 1973 study emphasized the division's responsibilities and the resources and procedures needed to fulfill those responsibilities. The study emphasized the need to formulate investment policy and to develop effective methods for accountability. Division officials indicated that the study resulted in some restructuring of the division and changes in investment strategy, such as the appointment of a deputy director and the increasing of stock holdings to 20 percent of the total Plan holdings.

Besides these external evaluations, the Division of Investment prepares (1) a fund analysis report for each pension fund every 3 years, (2) an evaluation of stock portfolios annually, (3) an evaluation of specific types of investments, such as common stock of public utilities, on a continuing basis, and (4) a report of securities transactions monthly. These internal analyses are made available to the council for review.

Disclosure statements

The New Jersey Department of the Treasury Code of Ethics were adopted in accordance with New Jersey's Conflict of Interest Law, which requires that all officers and employees who have outside interests with organizations doing business with the State file their disclosure forms annually.

Members of the council file disclosure statements approved by the New Jersey Executive Commission on Ethical Standards. Our review of these statements showed that 7 of the 10 council members are or were employed by New Jersey banks. Another member had a business relationship with a brokerage firm. The other members appeared to have no such relationships. The Executive Commission on Ethical Standards has determined that there would be no conflict of interest for a person to hold a position as employee of a bank doing business with the State and to also be a council member. The commission predicated this decision on the understanding that no member shall benefit from any transaction made by the Division of Investment. The council is reportedly aware that conflicts of interest could occur and it attempts to prevent such occurrences. Council members are prohibited from:

--Participating in the discussion or voting on investments which are offered for sale by their employer firms (except where competitively bid).

--Participating in the discussion or voting on investments which are offered for sale in their employer firm.

--Using information gained from their membership on the council for their own financial benefit or that of their employer firm.

The financial statements are circulated among the council members so that all are aware of others' interests.

The director, deputy director, and assistant director of the Division of Investment submit financial statements annually to the secretary of state. Other division employees are required to submit a certification of outside employment or business but are not required to submit financial statements.

The division director has proposed that each employee be required to sign a statement of business ethics and practices. This statement covers (1) the use of confidential information, (2) employment outside the division, (3) material relationships with banks or brokerage firms, (4) ownership and management of personal accounts, and (5) the employee's comportment in performing his or her duties. With respect to the ownership and management of personal accounts, it is proposed that employees submit a semiannual report of their securities transactions.

AUDIT AND DISCLOSURE OF INVESTMENT ACTIVITIES

The council hires an independent certified public accountant to audit the activities of the Division of Investment and the financial statements of the common pension funds. For each of the past 25 years, the council has requested an audit of the division's records and procedures by an independent public accountant. The Newark, New Jersey, office of a certified public accounting firm made the audits for the last 3 years. The last audit covered the year ended June 30, 1975. The council normally changes auditors every 5 years.

Scope of annual audits

A review of audit reports for 1971-75 showed that the audits included an examination of (1) the summaries of investments by major category of pension, trust, and State agencies' funds and (2) the related summaries of investment income by fund and investment activity.

The audits were basically financial in scope. The 1975 audit covered (1) inventory of securities, (2) investment income, (3) purchases of securities, (4) sale of securities, (5) redemptions, (6) prepayments on mortgages, (7) maturities, and (8) exchanges of securities. The audit included:

--Securities for which the division was accountable were confirmed with custodian banks.

--Interest income was confirmed with the funds and reconciled to division records.

--The cost of selected purchase transactions was compared to investment records.

--The gain or loss on sale of selected transactions was computed and compared to income records.

--The prepayment amount of selected mortgages was compared to statements from the mortgage servicing agent.

No significant exceptions or indications that prescribed procedures were not being followed were noted. Auditors' reports are provided to any interested person upon request.

Reports issued on
pension fund activities

The board is required by New Jersey statutes to submit a report annually on Plan operations. A review of the 1971-75 annual reports showed that the data reported included membership statistics, investment holdings and rate of return, assets and liabilities, revenue and expenditures, actuarial evaluation, and a list of members whose accounts had expired in the fund and who had neglected to withdraw their contributions. The annual reports were addressed to the Governor, and copies are sent to the State legislature and provided to members upon request.

The council also submits an annual report to the Governor, legislature, and the State treasurer on the activities of the Division of Investment. Information reported includes the report of the independent public accountant and summaries of investment by fund, income, major categories, and State agencies. The council provides the reports to any interested person upon request.

In addition, the director of the Division of Investment is required to prepare a monthly report detailing investment information (purchases, sales, and exchanges together with dates, prices paid and obtained, and the names of the dealers involved). The monthly report is to be made available to the State treasurer, the council, the press, and the public.

CHAPTER 3

INVESTMENT EXPERIENCE

ANNUAL RATE OF RETURN

The Plan's average rate of return on investment for the 3-year period 1973-75 was 6.01 percent excluding gains and losses on the sale of investments and 6.16 percent including such gains and losses. The following table shows the annual rate of return for each year, both including and excluding gains and losses.

Fiscal year	Percent of return: Excluding gains and losses	Percent of return: Including gains and losses
1973	5.73	6.09
1974	6.03	6.18
1975	6.22	6.20

In 1973 and 1974, net gains were realized on securities transactions, whereas in 1975 a loss was incurred. We developed the above rates of return based on guidelines published by the Committee on Public Employee Retirement Administration of the Municipal Finance Officers' Association. These guidelines provide for developing a rate of return by relating the actual income earned during the year to the average value of assets available for investment.

The Division of Investment computes a return rate based on the amount of dividends or interest income which would be received from investments on hand at yearend if the investments were held to maturity. Its computation does not reflect gains or losses in the market value of securities or gains or losses resulting from sales throughout the year. The rate developed is reported to the Governor and State legislature as well as the Plan's membership. For 1971-75, reported rates were 5.56, 5.75, 5.96, 6.36, and 6.37 percent, respectively, for the Plan.

PENSION FUND ASSETS

The value of Plan assets for fiscal years 1971-75 follows.

	(000 omitted)
1971	$ 692,931
1972	784,312
1973	890,072
1974	1,003,456
1975	1,128,353

A comparison of the Plan's assets by category for the 5 years is shown in the schedule on page 27. During the 5-year period, about 80 percent of the Plan's assets were invested in bonds and stocks.

FUNDS IN NON-INTEREST-BEARING ACCOUNTS

The Plan maintains two non-interest-bearing cash accounts--regular and investment. The regular account is a general fund account administered by the Division of Pensions and used to accumulate contributions from employees and employers; interest and dividends, employees' life insurance premiums, and transfers from other pension systems. The account is in turn reduced by such disbursements as payment of benefits to retirees, loans to members, transfers to other pension systems, death benefits, and insurance premiums. Cash balances exceeding immediate needs are transferred daily to the investment cash account. The Division of Pensions combines monthly receipts and disbursements for the two accounts when it determines cash balances. The following table shows the average monthly balance and expenditures for the two non-interest-bearing accounts for the last 6 months of fiscal year 1975. We computed each average monthly balance by totaling the beginning and ending balances and dividing by two.

	Cash accounts	
Month	Average monthly balance	Expenditures
January	$1,347,436	$39,747,924
February	1,166,107	41,573,845
March	1,096,434	30,699,297
April	1,366,410	38,545,360
May	1,560,115	35,489,992
June	3,331,080	53,219,336
6-month average	$1,644,597	$39,879,292

The chief accountant, Division of Pensions, did not believe that account balances of $1 million were unreasonable in view of (1) the variables involved in the timing of paying benefits, receiving contributions, and making loans to members and (2) the Plan's large size and numerous daily transactions. Other factors which increased average account balances were outstanding benefit checks and cost-of-living increase funds received at monthend.

The practice has been to keep as little cash as possible in the accounts to meet immediate needs. The large June balance was attributed to local governments submitting their share of contributions at the end of the fiscal year. Benefits to retirees would not be paid until the first day of July.

OPERATING COSTS

The costs incurred to operate the Plan include officer and employee salaries, legal and investigation costs, and general administrative expenses for the Division of Pensions and the Division of Investment. These costs are charged directly to each plan administered and allocated proportionally based on plan memberships.

The costs for fiscal year 1975 included $197,805 for the investment services provided by the Division of Investment to the Plan. For years before 1975, the division's costs were not allocated to pension plans. These costs were paid by the State from general funds and were not readily available.

The Plan's administrative expenses and contributions for fiscal years 1971-75 are shown below.

Fiscal year	Administrative expenses	Contributions	Percent of expenses to contributions
1971	$1,390,017	$ 84,112,378	1.7
1972	1,543,224	86,853,090	1.8
1973	1,700,364	100,009,390	1.7
1974	2,009,072	117,849,046	1.7
1975	2,356,328	133,468,781	1.8

SCHEDULE 1

THE PUBLIC EMPLOYEES' RETIREMENT SYSTEM OF NEW JERSEY

COMPARATIVE STATEMENT OF ASSETS

AS OF JUNE 30, 1971, 1972, 1973, 1974, AND 1975 (note a)

(Amounts--000 omitted)

Assets	1971 Amount	1971 Percent	1972 Amount	1972 Percent	1973 Amount	1973 Percent	1974 Amount	1974 Percent	1975 Amount	1975 Percent
Cash	$ 636	0.09	$ 1,075	0.14	$ 172	0.02	$ 1,894	0.19	$ 4,856	0.43
Temporary investments (note b)	23,642	3.41	17,148	2.19	24,853	2.79	35,294	3.52	41,233	3.65
U.S. Government securities	26,799	3.87	22,971	2.93	37,468	4.21	29,274	2.92	36,351	3.22
State and local government securities	5,938	.86	5,762	.73	4,497	.50	2,267	.22	2,053	.18
Corporate and other bonds	494,386	71.35	576,682	73.53	641,971	72.13	731,197	72.87	810,699	71.85
Common and preferred stocks	58,486	8.44	68,279	8.70	85,867	9.65	103,668	10.33	125,242	11.10
Mortgages	46,294	6.68	47,393	6.04	43,551	4.89	41,162	4.10	43,119	3.82
Other (note c)	36,750	5.30	45,002	5.74	51,693	5.81	58,700	5.85	64,800	5.75
Total	$692,931	100.00	$784,312	100.00	$890,072	100.00	$1,003,456	100.00	$1,128,353	100.00

a/Data obtained from annual reports published by the board of trustees and the Division of Investment.

b/Represents commercial paper and time certificates of deposits.

c/Represents real estate, loans to members, and accounts receivable.

APPENDIX II

CASE STUDY

ON

THE BOARD OF EDUCATION

EMPLOYEES' PENSION FUND OF

ESSEX COUNTY, NEW JERSEY

Contents

CHAPTER 1

BACKGROUND

The Board of Education Employees' Pension Fund of Essex County (hereafter referred to as the Plan) was established in accordance with the requirements of Chapter 112, Public Laws of 1929 of the State of New Jersey. The Plan is 1 of 38 identified contributory pension plans available throughout the State to public employees who are not members of State-administered plans. As of December 1975, the Plan had 5,532 active members and assets totaling about $36 million. In December 1975, the Plan paid about $109,000 to 518 retired members.

MEMBERSHIP REQUIREMENTS

Membership in the Plan consists of employees from 21 school districts within Essex County involved in noninstructional activities--administration, operations, maintenance, and medical services. Since 1929, the Plan has been greatly expanded by legislation. Current State legislation requires that permanent or provisional employees of boards of education will become members of county plans as a condition of employment if

--they were appointed on or after June 26, 1962;

--they are not covered by the State-administered Teacher's Pension and Annunity Fund; and

--the county has a population of over 600,000.

FUNDING

Funds needed to finance the Plan are contributed by both the employees and the boards of education of the 21 school districts. The enabling legislation requires that all members contribute 6 percent of their salary to the fund. Moreover, each board of education is required to pay into the fund each fiscal year the proportionate amount of the total contributions required from all employing boards of education as determined by an actuary. This should be sufficient to (1) provide for the pension credits being accrued by its members after taking into account contributions being made by the members and (2) provide for the payment of the unfunded accrued liability in annual payments over a 30-year period. In 1975 each board of education contributed to the fund an amount equal to 11 percent of the employees' salaries.

BENEFITS

Basically, six types of benefits are provided to members: (1) service retirement benefits, (2) non-service-connected disability retirement benefits, (3) service-connected disability retirement benefits, (4) non-service-connected death benefits, (5) service connected death benefits, and (6) deferred retirement benefits--vesting privileges. Details on two major benefits are outlined below.

Service retirement benefits

Any member participating in the fund on June 26, 1962, may retire when he has 30 years of service credit in the fund. Any member who attains age 60 may retire and receive an annual pension. The annual pension would equal one-sixtieth of the average salary in the 3 years before retirement multiplied by the years of service credit in the pension fund. For example, a member with 35 years of service credit who retires with a final average salary of $4,800 would receive an annual pension of $2,800 (1/60 x $4,800 x 35).

Deferred retirement benefits

A deferred retirement benefit, or "vested" benefit, is provided for a member with at least 15 years of service credit in the pension fund who leaves employment before reaching age 60. Such a member may elect to receive a deferred pension beginning at age 60. The annual pension would be equal to one-sixtieth of his average annual salary in the 3 years preceding his separation, multiplied by the number of years of credited service. If an employee's service is terminated before 15 years of service, his contributions are refunded with interest.

Cost-of-living annuity increases

Legislation enacted in 1971 requires that pensions be adjusted in the subsequent calendar year by at least one-half of the change in the Consumer Price Index. This adjustment is available to all pensioners who have been retired for at least 3 years. However, the adjustment is not available to an individual eligible to receive a pension under the Plan if he has been required to waive part or all of the pension because of his employment by another municipality or political subdivision of the State. The adjustment is funded by the employing governmental entities.

Life insurance

Another benefit provided to Plan members is group term life insurance. The amount depends on the age and compensation of the member. Additional insurance is available to members on a contributory basis.

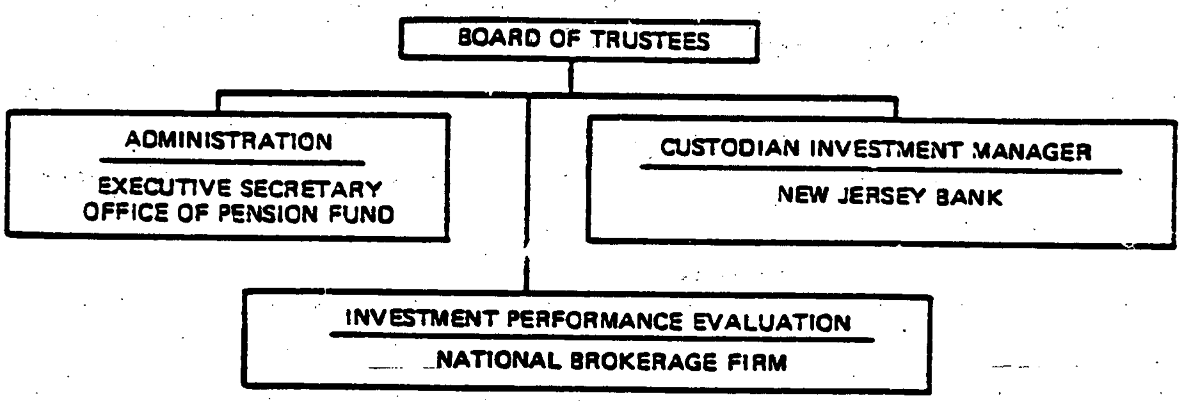
CHAPTER 2

FRAMEWORK FOR MANAGING INVESTMENTS

Under the enabling legislation, the Plan is controlled and managed by a board of trustees. The board is responsible to the 21 boards of education within the county for the proper operation of the Plan. The legislation authorized the board to invest Plan funds. To carry out its responsibilities, the board employs an executive secretary to handle the day-to-day administrative activities, a local bank to act as custodian investment manager, and a national brokerage firm to monitor the Plan's investment performance.

ORGANIZATIONAL STRUCTURE

The following structure was established to control and manage the Plan and handle related responsibilities.



Board of trustees

Legislation requires the board to have five members. Four of the trustees are members of the Plan who are elected by fellow members. The fifth trustee is the county superintendent of schools, who serves as a member ex officio. The commissioner of education appoints the individual to serve as county superintendent of schools. Board members elect a chairman, secretary, and treasurer. The chairman serves without compensation. The board fixes the salary of the secretary and treasurer. The two offices have been combined, and a trustee who serves as secretary-treasurer is paid $2,000 annually.

The board's responsibilities with respect to investment decisionmaking are discussed beginning on page 38. The board is also responsible for (1) disbursing pension funds, (2) depositing funds in banks or trust companies within the county, and (3) preparing an annual report for the district boards of education on the condition of the fund and the way funds are invested.

Executive secretary, Office of the Pension Fund

This office consists of six employees, including a chief administrator designated as executive secretary. It is responsible for the routine administration of the funds, including such activities as receiving employee and employer contributions, enrolling new members, determining retirees' benefits, maintaining individual members' accounts, and depositing funds in the bank. The executive secretary has also been directed to transfer all excess cash to the bank for investment.

The executive secretary is hired by the board of trustees and is authorized to hire administrative staff. The administrator advertises vacant positions in local newspapers and interviews job applicants. Prospective employees serve a 3-month probationary period before becoming permanently employed. Office personnel are employees of the Plan and responsible directly to the board of trustees.

Custodian investment manager

In 1969 the board contracted with a New Jersey bank to open a custodian investment management account. Under the agreement, the board authorized the bank to manage its investments and to physically hold securities. For these services, the board agreed to pay fees based on a percentage of the market value of the assets, with a minimum annual fee of $250. During 1975 the bank was paid fees of $14,161. Two other local banks were also considered as a potential investment manager. All offered the same services, but the bank selected had a lower fee schedule. This investment management bank also serves as a depository bank.

The bank's trust department manages the Plan's investments. The trust department is staffed with 118 people; details of their activities are outlined on page 42.

Investment performance evaluation

The board of trustees has retained a national brokerage firm, a member of the New York Stock Exchange, to provide formal investment evaluation and other services. The brokerage firm has agreed to provide formal quarterly performance evaluation reports showing results of the pension fund compared to results of other funds and related to such measures as Standard & Poor's 500 Stock Average and Moody's Average Corporate Bond Yields.

A discussion of the investment evaluation is included beginning on page 44. The brokerage firm has agreed to review the entire investment portfolio upon request by the bank or board of trustees and be available for discussions concerning investment decisions. It also makes available its institutional investment research pertinent to the pension fund investments so that further evaluations can be made.

MAKING AND IMPLEMENTING INVESTMENT POLICY

The board of trustees is authorized to invest and reinvest pension fund assets in:

--Bonds secured by first mortgages on improved property worth at least twice the amount loaned.

--Mortgages guaranteed or insured by agencies or instrumentalities of the U.S. Government.

--Other evidences of indebtedness, capital stock, or other securities issued by any company incorporated within the United States or Canada.

--Bonds and other evidences of indebtedness of the U.S. Government; any State, city, county, or school district; or the instrumentality of any State or of the U.S. Government.

The board is required to comply with the investment requirements for domestic insurance companies under New Jersey statutes. These statutes impose the following limitations.

--No more than 8 percent of the voting stock of any nonmunicipal corporation may be purchased.

--The amount invested in common stock of any corporation shall not exceed 2 percent of total fund assets.

--The common stock of all corporations valued at cost shall not exceed 15 percent of total fund assets except that, to the extent such investment exceeds 10 percent of total fund assets, it shall be subject to regulation by the commissioner of banking and insurance.

--The amount invested in preferred stock of any institution shall not exceed 5 percent of total fund assets.

The enabling legislation, as well as legislation relating to investments by insurance companies, provides the board with the only guidelines and limitations with respect to investments for the pension fund.

<u>Investment policies</u>

The board of trustees has established the following investment policy within the conditions and requirements of the enabling legislation.

--Conservative investment in relation to Standard & Poor's averages.

--Adherence to limitations established by legislation.

--Purchase of A-rated bonds or better.

--Prior written approval of the board for purchase of over-the-counter securities.

The attorney for the Plan has said that the assets of the fund in no way could be available for borrowing purposes to the State or any other agency upon demand. Such investments must be approved by the board.

The bank, with approval of the board, has established internal policies for managing the Plan's investments.

One consideration is to obtain the best rate of return possible within the expressed investment policy of the pension fund. For valuation in determining the contributions required to support the Plan benefits, the actuary assumes interest earnings at the rate of 5 percent per year. To insure the security of investments, the bank has established a policy of diversifying holdings in accord with legislative limitations. The bank reportedly also has a policy of not investing in local businesses because it believes better investments are available.

The following guidelines govern pension fund investments.

Fixed income securities

1. Bonds--The Plan invests in bonds which have at least an "A" rating or better from Moody's, a major rating agency. Issues that are downgraded in quality are monitored closely. Shifts in yield within quality groups and between different quality sectors of the market are monitored in order to take advantage of advantageous yield spreads. Bond maturities are staggered so the portfolio will never be entirely at the mercy of interest rates at any one time. This provides flexibility when used in conjunction with new money flows to take advantage of changes in the yield curve by investing funds at a better yield.

In general, bonds are purchased to be held to maturity. However, if, through temporary fluctuations in the market or interest rates, the Plan is able to shift to better rating groups or maturities to improve either quality or yield of investments, it will do so.

Investments in State and local obligations are not made even though they are legal investments. The reasoning is that, since the pension fund is tax exempt, there is no reason to invest in tax-exempt securities when a higher rate of return can generally be obtained from taxable securities.

At June 30, 1976, the Plan had about 91 percent of its investments in bonds.

2. Real estate mortgages--The bank has not invested any of the Plan's funds in mortgages. However, the board used to make loans to members. As of December 31, 1975, one mortgage loan remains outstanding with a balance of $5,170.

3. Preferred stocks--The bank maintains a list of about 280 stocks from which a "buy" list of 50 to 60 stocks is prepared. In determining whether or not a particular stock should be purchased, the bank examines the stock in relation to the overall outlook for the economy, the outlook for the stock's industry group within the economic framework, and its yield and potential for appreciation. The decision to sell is influenced by such factors, as the length of time the stock has been held, the amount of stock held, and whether the industry group or the stock itself is losing momentum and relative strength in the market.

If a stock is selling below cost, the bank attempts to sell it when the price has dropped 10 percent below cost or the industry group has not shown an increase in 4 months. A strong factor for selling at either a profit or loss is a decline in earnings growth momentum. In general, on a total return basis, the bank's objective is to obtain a one-third better dividend and appreciation in equities than that available from intermediate or longer term bonds. If this is not possible, there is little incentive to invest in equities.

As of June 30, 1976, the Plan had less than 1 percent of its investments in preferred stocks.

Common stocks

The Plan can invest up to 15 percent of the total fund assets in common stocks. The policy relating to common stocks is the same as that for preferred stocks. As of June 30, 1976, the Plan held about 6.7 percent of its investments in common stocks.

Short-term investments

For short-term funds awaiting investment, the bank daily checks about 10 or 15 sources of commercial paper and certificate of deposit rates. Most purchases of short-term paper are made directly from the issuer with the best rate on any given day and can be tailored exactly to the maturity date desired. As of June 30, 1976, slightly over 1 percent of the Plan's investments were short term.

Implementing investment policy

The board has given the bank's trust department full authority for managing the day-to-day investment activities of the Plan in accordance with the applicable laws and the trustees' expressed policy.

Each month the senior vice president in charge of the bank's trust department and the vice president for investments attend the meeting of the trust committee of the board of directors of the bank. They apprise the committee of the current state of the economy and the bond and stock markets and suggest policy to be followed. The suggested policy is the result of discussions held at the twice-weekly meetings of the trust investment committee, comprised of all the investment officers. Once approved, this policy flows back to the trust investment committee for implementation by the investment officers in handling their assigned accounts. At this point, the policy is implemented through specific programs in the individual accounts and passed on to the investment traders for actual execution.

The discussions and decisions of the bank's trust investment committee are influenced by (1) the trust department's internal research, (2) the results of external research by brokers with which they do business, and (3) input from the bank's other research and economic departments.

The investment officer in charge brings investment transactions before the trust investment committee for formal review. Accounts are under continuous review when a security comes up for consideration by the committee for either purchase or sale or when a bond matures or money is available for investment. Particularly in the equity area, the trust committee has given the trust investment committee the flexibility of adding or deleting stocks from the "buy" list in the interim between monthly trust committee meetings, with subsequent approval by the trust committee. This allows the trust investment committee to take advantage of market timing when appropriate.

This type of decisionmaking process is followed in the areas of equity, debt, and short-term investments. The decisions regarding debt and short-term investments include a discussion of maturity and quality as well as fixed income coverage.

Experience of the investment manager

The bank has been ranked 74th among U.S. commercial banks with total assets of over $2 billion. The trust department is actively involved in administering, investing, and handling the operations of personal trusts; guardianships; estates; investment advisory accounts; and both personal and employee benefits, pension, profit sharing, and welfare accounts. As of December 31, 1975, the trust department managed assets of approximately $400 million, not including custodian or corporate assets, which would bring the total to $1.3 billion. Included in the managed assets are about 152 employee benefit plans involving $150 million in assets. These plans include pension, welfare, thrift, or profit sharing and range in size from $50,000 to over $25 million.

Selection of brokers

Through agreements between the board of trustees and the bank and the brokerage firm, the board directed that the brokerage firm be appointed a broker of record for the Plan. According to the board, the bank was told to use the brokerage firm for security transactions if it was competitive. Bank personnel said that the brokerage firm handles 99 percent of the security transactions for the Plan because it was appointed broker of record and was competitive. Bank personnel stated that in 1975 about $30,000 in commissions was paid to the brokerage firm for stock transactions. The amount of these stock transactions was not readily available. During the same period, about $12 million worth of bonds were traded. The brokerage firm estimated fees of about $42,000 on these bond transactions.

MANAGEMENT AND CONTROL OF PENSION PLAN ASSETS

The board of trustees controls the management of pension plan assets through its monthly meetings. Personnel from the bank and the brokerage firm are required to attend. The activities are reviewed by the board and if found acceptable are ratified. These meetings are also the focal point for an ongoing reevaluation of investment policies and practices. In addition, the board receives quarterly performance evaluations from the brokerage firm.

According to the bank's trust department personnel, intentional investment in bank customers or channeling of commissions to brokers having large accounts with the bank is precluded because the bank's commercial department handles these customers and account data for them is not maintained by the trust department.

Money management techniques

The bank analyzes daily and weekly computer-prepared cash statements to insure that cash balances are invested immediately upon receipt. A daily statement is prepared showing cash available for investment from earnings. A weekly statement is prepared showing cash available for investment from the sale and maturity of securities. Any cash in the Plan's regular checking account available for investment is transferred by the executive secretary to the investment account with the bank. The bank immediately invests these transferred funds.

As discussed on page 41, the bank has a policy of investing cash in short-term commercial paper until it is needed for a more permanent investment. The bank normally buys bonds to be held to maturity, but it will shift to better rating groups or maturities when this is advantageous to the fund.

Monitoring investment performance

Procedures

The brokerage firm provides an investment performance analysis which applies a two-dimensional view of performance. First, the of rate of return is calculated. Secondly, the portfolio's risk character is quantified. Risk and return are then related in a summary view of performance.

The analysis of the portfolio is divided into various components. The equity's portion of the portfolio is analyzed in relation to the Standard & Poor's 500 Stock Average in terms of level of return and measure of investment risk as a degree of sensitivity to stock market fluctuations. The fixed income investments' rates of return are analyzed in relation to a hypothetical portfolio based on Moody's average of high-grade corporate bond yields. Cash equivalents' (fixed income obligations with maturity of less than 1 year at time of purchase) rates of return are analyzed in relation to the rates available in the money market. Finally, rates of return statistics are provided on the total portfolio.

The analysis also includes a section on allocation of funds, which measures the success achieved in timing moves into and out of the various sectors of the portfolio in anticipation of market effects. The detailed investment performance analysis is furnished in the final quarter of each calendar year and updated quarterly for the succeeding 3 quarters.

As part of the investment performance analysis, a comparative survey is prepared annually covering a 5-year period. This compares the performance of the fund with the results achieved by other money managers for representative groups of (1) professionally managed retirement funds, (2) bank-commingled funds, and (3) mutual funds. Comparisons encompass rates of return, market sensitivity, and other important performance characteristics.

The brokerage firm also provides analysis specialists to discuss and explain the reports to the board of trustees. The institutional account executive assigned to the Plan attends the monthly meetings of the board to explain why a particular security was bought or sold. He answers any questions the trustees may have relating to investments of the fund.

Performance

According to the secretary-treasurer of the board of trustees, the board is not completely satisfied with the bank's management of the fund's investments. The bank has incurred sizeable losses on the sale and redemption of securities during the past several years. Losses were incurred in 4 of the 5 years between 1971 and 1975. In each of the past 2 years, these losses amounted to almost $1 million. The bank had been investing the fund's assets in equities in excess of the limitations established by the State laws which govern the operation of the Plan. In 1975, the Plan sued the bank on the theory that investments had been made in violation of the statutes. Under a settlement approved by the courts as being in the best interests of the fund, the bank agreed to pay the fund $900,000 in services and money over a 10-year period.

The board of trustees, in its continuing review of investment policy, has interviewed several other money management firms, including out-of-State firms.

Disclosure statements

The Plan does not require the board of trustees or its administrative employees to file disclosure statements showing potential conflicts of interest.

AUDIT AND DISCLOSURE OF INVESTMENT ACTIVITIES

The Plan uses independent certified public accountants selected by the trustees to audit its pension plan activities annually. A local firm has performed the annual audit since the Plan was established in 1929. The last report completed was for the year ended December 31, 1975.

Scope of annual audits

A review of audit reports for 1971-75 showed that the audits included an examination of the statement of condition of the pension fund and the related statements of operations, reserves, and changes in financial position.

The audits, which were basically financial in scope, included:

--Confirming the amount of cash in bank accounts; investments in stocks, bonds, and other securities; and outstanding mortgage loans.

--Confirming balances on deposit with the insurance company as part of the life insurance program offered plan members.

--Confirming contributions receivable from various school districts.

--Testing transactions related to employer and employee contributions, interest, dividends, and expenditures.

--Examining insurance policies in effect.

Securities the bank holds as investments for the fund are reviewed yearly to determine if they are held in accordance with limitations imposed by New Jersey statutes. The auditors pointed out in their audit reports for 1973 and 1974 that the Plan's investment stock portfolio exceeded the limitations set forth in legislation.

Reports issued on pension fund activities

Enabling legislation for the Plan requires the board of trustees to make an annual report of the condition of the fund and the manner in which it is invested to the boards of education of the school districts within the county. The report is to be made each March for the previous calendar year. The board of trustees furnishes a copy of the report to each member of the Plan. A review of annual reports for the last 5 years (1971-75) showed that the report is issued in January and includes the following information:

--Narrative on Plan activities during the year.

--Membership report and analysis.

--Unaudited financial report (statement of receipts and expenditures and balance sheet).

--Narrative regarding investment activity.

--Summary statement of investment assets held as of December 31 and estimated annual income on these investments.

The audited financial reports are also distributed to each school district.

In addition, an annual meeting of Plan members is held each January in accordance with New Jersey statutes and the Plan's bylaws. The purpose of the meeting is to elect a trustee for a 4-year term. Such matters as the financial status and actuarial soundness of the fund and the investment portfolio are also discussed.

CHAPTER 3

INVESTMENT EXPERIENCE

ANNUAL RATE OF RETURN

The following table shows the annual rate of return on investments for each of calendar years 1971-75, both including and excluding realized gains and losses.

Calendar year	Percent return: Excluding gains and losses	Percent return: Including gains and losses
1971	5.91	3.90
1972	5.46	7.82
1973	5.76	3.58
1974	6.64	2.75
1975	7.04	3.62

In every year except 1972, the Plan realized a net loss on the sale and redemption of securities. We computed the above percentages on the basis of yield computation guidelines published by the Committee on Public Employee Retirement Administration of the Municipal Finance Officers' Association. These guidelines provide for determining average investable assets during the year related to actual income earned during the year.

The bank computes the rate of return based on the cost of the invested assets at the end of the year related to the estimated income those assets will earn over the next year if held intact. Brokerage commissions are included in the cost of the securities. This rate of return is reported to the members in the annual report. The Plan reported an estimated 6.82-percent return for 1975.

PENSION PLAN ASSETS

The value of the Plan's yearend assets shown in audited financial statements for calendar years 1971-75 is as follows:

1971	$17,033,703
1972	21,360,681
1973	24,830,150
1974	31,027,912
1975	36,343,030

A comparison of the Plan's assets by category for the 5-year period is shown in the schedule on page 52. During the 5-year period, about 83 to 89 percent of the Plan's assets were invested in long-term securities, such as bonds and stocks. Bond and stock investments consisted of a mix according to the criteria followed by the Bank. (See p. 40.)

FUNDS IN NON-INTEREST-BEARING ACCOUNTS

The Plan currently maintains four non-interest-bearing commercial checking accounts, and the bank maintains two non-interest-bearing custodial accounts. These include a regular account for cash receipts from contributions, a contributory insurance account, a pension account, a payroll account, and custodial accounts for income cash and principal cash. The following table shows, for the last 6 months of 1975, the average monthly balances and expenditures for the regular and custodial accounts.

	Regular account		Custodial accounts: Income cash		Custodial accounts: Principal cash	
Month	Average monthly balance	Expend-itures	Average monthly balance	Expend-itures	Average monthly balance	Expend-itures
July	$706,990	$151,407	$ 999	$176,169	$ 93,724	$4,199,573
August	583,794	640,852	624	204,224	-29,521	3,265,335
September	323,139	177,650	0	188,765	154,968	1,672,845
October	277,666	288,412	2,349	170,098	129,699	3,339,720
November	251,720	144,120	2,349	116,885	-16,326	1,920,500
December	301,847	185,468	6,282	131,516	23,781	1,353,447
6-month average	a/$407,526	$264,652	$2,100	$164,610	$ 59,387	$2,625,237

a/We computed a daily average balance for the 6-month period by dividing the sum of the daily ending balances by the number of calendar days in the period. This daily average balance amounted to $333,736.

We computed the average monthly balances for the above accounts by totaling the beginning and ending balances and dividing by two.

According to the executive secretary for the Plan, the large balance in the regular account was due primarily to the following: (1) late in 1975, the Newark Board of Education laid off many employees and the cash requirements for withdrawals of contributions were not known and (2) because of staffing problems, proper attention is not given to monitoring the regular account. The account is reviewed monthly rather than daily. The executive secretary plans to train an office employee to monitor this account daily.

Bank personnel said the credit balances appearing in the principal cash account are due to overdrafts occurring when a security has been purchased and money has not yet been received for securities sold. Overdrafts also occur in that account when income cash is invested but has not yet been transferred to the account. Transfers are made only at the end of each month; however, cash shown in the income account would be invested during the month.

The contributory insurance account consists of contributions from Plan members for contributory group life insurance. The contributions are deposited in this account monthly as received. The only activity against the account is the payment of the premium during each March and infrequent refunds to members for excessive contributions. During March 1976, the contributory insurance premium of about $422,000 was paid. At that time, the contributory insurance account had a balance of about $275,000. An additional $147,000 was transferred from the regular account to cover the total premium.

The pension and payroll accounts maintained by the bank are for the payment of pensions and payrolls. As soon as the cash requirements are known, a transfer is made to these accounts and checks are immediately drawn for making the payment.

The secretary-treasurer of the board of trustees expressed concern over the high cash balances in non-interest-bearing accounts. We were told these accounts--including the contributory insurance account--would be reviewed with the objective of investing funds not needed for operations in the immediate future.

OPERATING COSTS

The costs incurred to operate the Plan include such administrative expenses as salaries; office rent; printing and postage; and fees covering accounting, legal, actuarial, and advisory services. Brokerage commissions are not included in the operating costs because they are included in the cost of securities.

The Plan's yearly administrative expenses for 1971-75 and a comparison of expenses to the net contributions to the fund for providing retirement benefits are shown below.

Year	Administrative expenses	Contributions	Percent of expenses to contribution
1971	$ 52,520	$3,312,349	1.59
1972	81,954	4,105,218	2.00
1973	96,055	4,312,507	2.23
1974	114,070	5,805,273	1.96
1975	140,683	6,074,114	2.32

SCHEDULE 1

THE BOARD OF EDUCATION EMPLOYEES' PENSION FUND, ESSEX COUNTY, NEW JERSEY

COMPARATIVE STATEMENT OF ASSETS AS OF

DECEMBER 31, 1971, 1972, 1973, 1974 AND 1975 (note a)

Assets	1971 Amount	1971 Percent	1972 Amount	1972 Percent	1973 Amount	1973 Percent	1974 Amount	1974 Percent	1975 Amount	1975 Percent
Cash	$ 156,683	0.92	$ 972,619	4.56	$ 300,623	1.21	$ 195,962	0.63	$ 592,468	1.63
Temporary investments:										
Commercial paper	-	-	-	-	355,000	1.43	848,000	2.73	500,000	1.38
Floating rate notes	-	-	-	-	-	-	100,000	.32	100,000	.27
U.S. Government securities	-	-	98,931	.46	300,000	1.21	29,796	.10	-	-
State and local government securities	45,528	.27	45,528	.21	45,528	.18	-	-	-	-
Corporate and other bonds	12,434,075	73.00	11,981,408	56.09	14,972,072	60.30	21,393,059	68.95	27,521,516	75.73
Common and preferred stocks	2,690,454	15.79	6,317,359	29.58	6,590,602	26.54	4,317,534	13.91	2,572,136	7.08
Mortgages	-	-	-	-	-	-	-	-	-	-
Other (note b)	1,706,963	10.02	1,944,836	9.10	2,266,325	9.13	4,143,561	13.36	5,056,910	13.91
Total	$17,033,703	100.00	$21,360,681	100.00	$24,830,150	100.00	$31,027,912	100.00	$36,343,030	100.00

a/Data obtained from Essex County Plan independent audit reports.

b/Represents such assets as mortgage loans to members, contributions receivable, accrued interest, and amounts on deposit with the Prudential Insurance Company.